Muirfield Capital Global Advisors

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Comment Letter on Re-Proposed Enterprise Capital Framework

Summary

Muirfield believes that FHFA should set capital standards for post-Conservatorship Fannie Mae and Freddie Mac at levels where they can operate safely and soundly and that assure that American taxpayers are reasonably protected from possible future losses. However the FHFA also needs to balance the desire to have large, bullet-proof balance sheets with the costs of that capital, which ultimately is translated into the level of guarantee fees the GSEs must charge their customers, approximately 50% of the homeowners in the US. Requiring excessive capital requires higher GSE guarantee fees and creates a tax that is ultimately borne by all Americans through higher mortgage costs, higher rents and lower home values.

Muirfield is concerned that the Re-Proposed Capital Framework (the "Proposed Capital Rules") errs substantially in requiring excessive and unnecessary capital. Further the Proposed Capital Rules are structured in a way that prevents the GSEs from obtaining capital in the most cost-efficient manner from the public capital markets. The combined result will lead to higher GSE guarantee fees than necessary.

Consistent with the Treasury Plan published September 2019, we recommend that Treasury continue to provide a credit support backstop to the GSEs and the Treasury contingent commitment replace all or a substantial portion of the newly proposed Buffer Capital. This would have broad public policy benefit for all Americans by minimizing GSE Guarantee Fees, mortgage costs and rental costs and by increasing home values.

Background

Muirfield Capital Global Advisors is the manager of the Muirfield GSE Partners Fund, which is a shareholder of the Government Sponsored Enterprises Fannie Mae and Freddie Mac (collectively, the "GSEs"). We believe that Fannie and Freddie provide important benefits to the US citizens and the economy by providing liquidity to the housing mortgage markets, especially in times of financial stress, as we have recently witnessed. The GSEs facilitate a low-cost 30-year fixed rate mortgage which enables many Americans to afford to own a home. Moreover, they also assure the availability of mortgage financing, which provides liquidity to the most valuable asset of most American families.

Muirfield's principals have expertise in the area of Investment Banking as we have approximately 100 years of combined experience. Our Chairman was previously the Chairman and Chief Executive Officer of Donaldson, Lufkin & Jenrette, a highly successful bulge bracket investment bank sold to Credit Suisse in 2000.

We have researched extensively the historical and current performance of the GSEs including the periods before and after the Global Financial Crisis as well as the more recent environment of recovery and, in 2020, the disruption by the Coronavirus. We consider ourselves experts on the matter of the prospective GSE recapitalization.

The GSEs' Role in the Transformation of the Mortgage Market

Fannie Mae was created during the Great Depression to address the lack of mortgage availability in the United States. Mortgage defaults were in excess of 25% and property values declined drastically, in large part to the lack of availability of mortgage financing from the highly stressed US banking system. Many prominent economists concluded that the extreme depth of the Great Depression was due to a lack of liquidity in the banking and financial system. Fannie, and later Freddie, were created to address these liquidity issues for the mortgage markets.

Prior to the late 1980s the bulk of US mortgages were financed by mortgage centric savings institutions, called thrifts or savings and loans, and banks. These institutions issued long-term fixed rate mortgages and funded them with short-term deposits. After the US experienced high inflation in the 1970s many these institutions faced insolvency because they held long term mortgage assets with low interest rates and had to fund them with short term funds at higher rates. This fundamental funding basis risk led to increased risk taking to earn their way out of the problem, eventually resulting in the Savings and Loan Crisis. The Savings and Loan crisis led to the elimination of a major source of mortgage financing and a decline in US real estate prices.

Fortunately a capital markets innovation in the form of mortgage securitizations provided a new, more efficient funding solution for mortgages. In simplest form, mortgage securitizations separate the credit risk of mortgages from the interest rate risk that ruined the Savings and Loans. Fixed income investors purchase the yield component and receive the bulk of the interest rate charged on the mortgage. These fixed income investors are often insurance companies, pension funds, sovereign wealth funds or other investors seeking longer duration investments. The credit risk of mortgages is taken by Fannie and Freddie who provide a credit guarantee against any credit losses and receive a guarantee fee, currently approximately 43 basis points per year on average. Fannie and Freddie are essentially domestic monoline insurance companies that issue credit insurance on a large diversified pool of mortgages. The separation of these fundamental risk components of mortgages has enabled a more efficient, lower cost mortgage solution than the historical bank and savings and loan structure.

The Difference Between Banks and the GSEs in the Mortgage Market

There are many significant differences between banks and the GSEs that make their comparison more of an apple to oranges comparison rather than a comparison of peers. As a result, the adoption of bank-like capital definitions and standards in the proposed Capital rules isn't appropriate.

When banks hold mortgages they assume both the interest rate risk and the credit risk of the mortgage, whereas the GSEs only hold the latter. This enables banks to earn all of the interest on the mortgage, rather than just the smaller slice that the GSEs receive for just assuming the credit risk. The banks are taking substantial interest rate basis risk not borne by the GSEs. This interest rate basis risk seems minor as we've been in a period of declining interest rates for almost 30 years. However, Banks still obtain the bulk of their capital from short term funding sources, including Federally Insured demand deposits. If they make 30-year fixed rate mortgages at today's historically low rates they may find themselves in the future with a mismatch of low yielding long-term mortgages and higher cost short-term funding, the same problem that caused the demise of the Savings and Loan industry. It's obvious that this additional funding risk carried by the banks requires more capital than the credit only risk of the GSEs. So on an apple to apples basis, banks should be required to carry substantially more capital against their mortgage portfolio than the GSEs. The idea that the GSEs should have the same risk weights as banks for mortgages when they hold only a fraction of the risk is inherently illogical.

Another important difference between domestic GSEs and multinational banks is that the business of the banks is often highly complex and difficult to analyze from a risk perspective. Unlike the GSEs, the balance sheet of a major bank doesn't consolidate all of it's potential exposure. There are exposures to counter-party risk in trade credit, currencies, commodities, and other products. Derivatives exposure calculations are also extremely difficult, which was exposed when major banks suffered large losses on exposure to sub-prime credit derivatives in 2008. The complexity of banks and the difficulty in agreeing on a uniform measure of the risks of their various businesses is why Basel 3 bank capital standards are driven by minimum leverage ratios, rather than relying on stress test analysis.

By comparison, the business risks of the GSEs are much easier to evaluate and model. They have a monoline domestic business that insures against the loss of principal and interest on a large, highly diversified pool of mortgages. And like insurance companies they have an existing portfolio of policies that will continue to perform and pay insurance premiums for several years after an event that causes some small portion of the portfolio to default. So they have the ability to re-build their capital buffers through future premiums they will receive. Unlike the complex banks, the GSEs have business models that can easily be risk assessed through stress tests. For reasons that are unclear, FHFA has decided to not use the more modern, sophisticated risk analysis that is available but is rather trying to shoehorn the GSEs into a leverage ratio based on bank capital models.

The Capital Rules as Proposed are Inefficient

We share the view of many others that the absolute levels of Capital proposed are unnecessarily high relative to the business risks of the Companies. We further believe that the Capital Rules could be modified to permit other forms of capital to be utilized to lower the required cost of capital for the Companies and permit them to charge lower guarantee fees. An inefficient capital structure creates unnecessary costs for the Companies which ultimately leads to higher guarantee fees for their ultimate customer, the American homeowner.

With regard to the absolute levels of capital required, it's clear that the proposed total of 4.00% of assets, or $240 billion, is too high[1]. We have the following observations:

1. The Dodd-Frank Stress tests of the GSEs indicates a potential loss of $18 billion in a highly stressed environment. The GSEs don't require minimum capital of 9x to 13x that amount to continue to operate safely and soundly.
2. The GSEs should generate annual net income of $15 to $20 billion of normalized earnings. The potential losses from the Dodd-Frank stress test scenario would be recovered in one year's earnings. The Companies aren't static and a snapshot analysis that fails to consider the future Guarantee Fee income of the Companies is unnecessarily punitive.
3. The purported losses of the GSEs from the 2008 financial crisis are not indicative of potential losses from their current portfolios. A large portion, if not the majority, of the actual losses realized by the GSEs related to Alt-A or sub-prime mortgages they guaranteed. These types of exceptionally risky mortgages haven't been purchased since 2009 and represent only a

[1] We will focus on the capital required by the leverage ratios, which are controlling and require the highest capital levels.

small portion of their current portfolios. There was also widespread misconduct in the mortgage origination process that led to widespread mortgage fraud that victimized the GSEs. The GSEs have received legal settlements of over $20 billion from major US banks to offset a portion of the losses they incurred. The advertised losses from the 2008 cited in the Proposed Capital Rules include substantial non-cash accounting charges, many of which proved to be too draconian and were later reversed.

4. In the wake of the 2008 crisis there have been substantial enhancements to the mortgage underwriting processes to eliminate fraud and assure sound appraisals of home values. Mortgage originators are also subject to loan re-purchase obligations.
5. The present portfolios guaranteed by the GSEs have an average loan to value of approximately 60% and a default rate of only .30% on loans originated after 2009[2]. Further there is substantial CRT risk-loss mitigation protecting the bulk of potential loan losses.

In summary, the risk in the GSE mortgage portfolios today is far less than existed in 2008 and the Proposed Capital rules should reflect that reality rather than to protect against a mathematical repeat of 2008. Many of the problems of 2008 were caused by a failure of regulatory oversight and business practices that haven't existed for over 12 years. Requiring levels of capital that are 9x to 13x the amount required by Dodd-Frank Stress Tests doesn't pass the commonsense test.

Modify the Capital Rules to Permit Lower Cost, More Efficient Capital Structures

One means to reduce the required guarantee fees that the GSEs must charge is to modify certain aspects and definitions to permit the GSEs to raise capital in the lowest cost manner. The amount of capital the GSEs must raise under the proposed rules will be the largest capital raise in history for any company. In order to raise this capital in a cost-efficient manner, FHFA must allow the GSEs to access as many low-cost capital sources as possible.

In our view, many of the definitions of allowable capital can be modified to permit a lower cost, more efficient capital structure without sacrificing the safety and soundness of the enterprises. Certain of the capital definitions appear to be rooted in the 1992 legislation, which was drafted almost 30 years ago and doesn't reflect the range of capital markets options available today. Certain definitions can be modified with respect to the enhanced capital requirements envisioned by the proposed rules.

For purposes of this discussion we'd like to suggest separating the capital definitions for the minimum base capital requirements of 2.50% ("Base Capital") from the additional 1.50% of proposed buffer capital ("Buffer Capital").

To reduce the cost of Base Capital[3] we have several suggestions.

1. <u>Permit Increased Use of Preferred Stock</u> – Several analysts have suggested that the required rate of return for common stock for the GSEs is in the range of 10% to 12%. Perpetual Preferred Stock that is non-cumulative will require a lower yield, perhaps in the range of 6.00%. Perpetual Preferred Stock is permanent capital that cannot cause a default. There is no reason to arbitrarily limit the use of Perpetual Preferred Stock to only 25% of Base

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[2] Mortgage default rate as of December 31, 2019, prior to Covid pandemic.

[3] To accommodate certain of these provisions the Base Capital objective may have to be differentiated from Statutory Capital

Capital. The limit could be increased to 40% or even 50% at no risk to the solvency of the Companies.

2. Permit Cumulative Perpetual Preferred Stock. The GSEs have $33 Billion par Value of Non-Cumulative Preferred Stock outstanding. No dividends have been declared or paid on these shares since 2008. Given the history of disputed government actions during the Conservatorships it may be difficult to raise substantial additional amounts of non-cumulative Preferreds. Enabling the GSEs to issue Cumulative Perpetual Preferred stock would enable them to offer a more attractive, differentiated security to fixed income- oriented buyers. Cumulative Preferred shares could be sold in greater amount and at a lower dividend yield than similar non-cumulative securities. They can be structured in a manner to eliminate any risk of default. US Bank regulators permit Cumulative Preferred stock to be considered as Capital for many US banks.
3. Permit Some Portion of Base Capital to be Long Lived Subordinated Debt. Similar to the idea of offering Cumulative Preferred stock, permit a certain amount of Base Capital to consist of Subordinated debt with a long maturity. This would be attractive paper for long-duration fixed income buyers and very low-cost for the GSEs, as they could deduct the interest for tax purposes.
4. Permit Dividend Payments on Common Stock to Upsize Re-IPO Offerings. The GSEs will be highly profitable but have limited growth prospects. They will operate like utilities with regulated guarantee fees and little opportunity for growth. They will require a dividend yield to be attractive to investors. The proposed capital rules prohibit common or preferred cash dividends until Base Capital is achieved. The Companies could raise the capital more quickly if they are allowed to pay a portion of their earnings as cash dividends at the initial re-IPO dates. Larger IPOs and follow-on offerings can raise Base Capital more quickly than saving $4 billion a year in retained earnings by not paying dividends.

Treasury Commitment to Backstop Buffer Capital

Buffer Capital is a redundant capital concept introduced by the Proposed Capital Rules. It's a substantial additional amount of capital that isn't required for the Companies to legally operate, but rather a condition that must be achieved for the Companies to be able to distribute large amounts of earnings to shareholders and pay discretionary cash bonuses to management. It appears to be a belt and suspenders approach to adding large amounts of capital to the already substantial Base Capital requirements. Nice to have but not critically necessary. If raised through public offerings of common stock it creates the prospect of huge additional dilution by high cost capital, requiring higher guarantee fees to be paid by American homeowners.

It can be considered as a "second-loss" type security that would only have loss exposure after $150 billion of catastrophic losses at the GSEs, certainly a highly improbable event. We propose that Treasury extend the PSPA to provide a back-stop credit facility to fund all or a substantial portion of the Buffer Capital in the event the Core Capital levels of the GSEs fall below a certain level. Treasury would be paid a fee for this back-stop facility. But as an unfunded commitment, the cost would be substantially less than a funded security. This backstop commitment has been formally contemplated by Treasury's proposed GSE Privatization Plan but has been ignored by FHFA in the Proposed Capital Rules for reasons that are unexplained.

There would be broad benefits to such an arrangement. The GSEs could raise Core Capital in greater size and more quickly in the public markets without the overhang of substantial equity dilution for an additional large amount of Buffer Capital. The total cost of capital for the GSEs would be lower than if Buffer Capital has to be funded in the public markets, thereby enabling them to charge lower guarantee fees. American homeowners would benefit from lower Guarantee fees and thereby lower mortgage costs. Treasury would also benefit because there would be substantial first-loss capital in front of US taxpayer risk sooner than otherwise and Treasury would be compensated for an explicit credit backstop rather than receiving no compensation for a widely perceived implicit backstop.

Engineering the right solution for the GSEs requires balancing the needs for safety and soundness with the duty to serve. The Proposed Capital Rules miss this balance by overfunding the GSEs to the point that guarantee fees borne by homeowners will need to increase significantly to enable investors to fund the GSE at such excessively high capital levels. As a practical matter, the capacity of the GSEs to serve will diminish as homeowners look to other non-GSE alternatives. Our proposals provide a simpler alternative approach which more than adequately provides sufficient capital for the GSEs to serve their mandates without imposing unnecessary costs on American homeowners.

Respectfully submitted,

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